Webb's Fabulous Pharmacies, *Phillips*, and *Brown*. Petitioner's reliance on those decisions is misplaced.

In *Webb's Fabulous Pharmacies*, the appellant, a Florida corporation, filed a complaint in interpleader in county court and tendered nearly $2 million to the court. 449 U.S. at 156-157. The clerk of the court deposited the money in an interest-bearing account, *id.* at 157, deducted $9228.74 as a service fee, *ibid.*, and also retained the interest earned on the fund, which ultimately totaled approximately $100,000, see *id.* at 158. *Phillips* and *Brown* involved the implementation of Interest on Lawyers Trust Account (IOLTA) programs. "Under these programs, certain client funds held by an attorney in connection with his practice of law are deposited in bank accounts," and "[t]he interest income generated by the funds is paid to foundations that finance legal services for low-income individuals." *Phillips*, 524 U.S. at 160; see *Brown*, 538 U.S. at 220-223.

As the court of appeals recognized, "[t]he 'interest follows principal' cases relied upon by [petitioner] all involved situations where third parties held plaintiffs' funds in separate interest-bearing accounts." Pet. App. 14a; see *Brown*, 538 U.S. at 221-222, 235; *Phillips*, 524 U.S. at 161-162; *Webb's Fabulous Pharmacies*, 449 U.S. at 156 n.1. In *Webb's Fabulous Pharmacies* and *Phillips*, the Court held that ownership of the interest earned from third parties "follow[ed]" the (undisputed) beneficial ownership of the principal. *Id.* at 163-164; *Phillips*, 524 U.S. at 165.[2] In *Brown*, the Court "as-

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[2] Petitioner asserts (Pet. 12) that Texas law "applies to define 'property' in this case." That is incorrect. Federal law governs petitioner's deposits with a federal instrumentality. Cf. *United States* v. *Chandler*, 410 U.S. 257, 261-262 (1973) (holding that fed-

sume[d]" that interest generated by the IOLTA accounts "was taken for a public use when it was ultimately turned over to" a charitable foundation. 538 U.S. at 235. The Court held, however, that the State of Washington was not required to pay compensation to the petitioners whose funds had been deposited in IOLTA accounts because, under the terms of the program, client funds were permitted to be deposited in IOLTA accounts only when those funds were otherwise incapable of generating net income for the client. *Id.* at 239-241.

This case differs fundamentally from *Webb's Fabulous Pharmacies*, *Phillips*, and *Brown*. The claimants in those cases sought to recover interest that had accrued on a claim held by a depositor or bond holder. They did not seek to recover profits that were earned by the institutions *in which* the funds had been deposited or invested. Petitioner, by contrast, claims to "own" the income earned by a Reserve Bank itself upon funds allegedly deposited at the Reserve Bank. See, *e.g.*, Pet. 3. Thus, it is as if the plaintiffs in *Brown* or *Phillips* had claimed a share of the earnings of the third-party banks at which the client trust funds were deposited; or as if the plaintiff in *Webb's Fabulous Pharmacies* had sought a share of the profits of the third parties that issued the securities in which the interpleader monies were invested. Petitioner identifies no decision of this Court or any other court that has applied the "interest follows principal" rule in analogous circumstances.

In *Brown*, this Court explained that IOLTA programs first became feasible in 1980, when Congress authorized individuals and charitable organizations to de-

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eral law governs the transferability of United States Savings Bonds).

posit money in "NOW" (interest-bearing checking) accounts. 538 U.S. at 221. The Court further explained that "[b]efore 1980 client funds were typically held in non-interest-bearing federally insured checking accounts," *ibid.*, and that "the banks retained the value of the money deposited in" those accounts, *id.* at 221-222. The Court's analysis clearly presumed that, under the pre-1980 legal regime, clients who entrusted funds to their attorneys were not entitled to interest, even though the banks in which those funds were held no doubt earned income by investing the funds deposited in those accounts. Similarly here, when petitioner deposits reserves in a non-interest-bearing Federal Reserve Bank account, the Federal Reserve is entitled to "retain[] the value of the use of" the money, *ibid.*, including any income earned by investing the deposited funds.

3. Petitioner contends (Pet. 17-20) that this case presents an issue of substantial practical importance because some federal officials with relevant expertise believe that the payment of interest on required reserves would assist the Federal Reserve's efforts to implement sound monetary policy. Far from accepting that view of the matter, however, Congress has repeatedly declined to authorize the Federal Reserve to pay interest on required reserves. Congress is of course required to implement its policy choices in a manner consistent with the Constitution, but "[t]he wisdom of Congress' action * * * is not within [this Court's] province to second-guess." *Eldred* v. *Ashcroft*, 537 U.S. 186, 222 (2003). Petitioner's contention that the failure to pay interest on required reserves represents an unsound federal policy therefore provides no basis for this Court's review.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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No. 05-1168

IN THE

Supreme Court of the United States

TEXAS STATE BANK
(SUCCESSOR BY MERGER TO COMMUNITY BANK & TRUST),
Petitioner,

v.

UNITED STATES,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Federal Circuit

REPLY BRIEF FOR PETITIONER

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UNITED STATES,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Federal Circuit

REPLY BRIEF FOR PETITIONER

Petitioner Texas State Bank submits this reply brief in response to Respondent's contention that the decision of the Court of Appeals does not conflict with any decision of the Court. Respondent's conclusion is premised on three fundamental mistakes of fact and law which, when corrected, lead to the indisputable conclusion that the lower court's decision is in direct conflict with *Webb's Fabulous Pharmacies, Inc. v. Beckwith*, 449 U.S. 155 (1980), *Phillips v. Washington Legal Foundation*, 524 U.S. 156 (1998) and *Brown v. Legal Foundation of Washington*, 538 U.S. 216 (2003).

Respondent's underlying assertion is that the relationship between the Federal Reserve Bank and the Petitioner is simply that of a debtor and creditor. According to Respondent,

because Petitioner places its reserves in a non-interest bearing account at the Federal Reserve Bank, Petitioner is a creditor who has no cognizable property interest in the earnings generated by such reserves. Respondent, however, ignores the critical distinction that unlike a typical depositor who chooses to place deposits with a bank based upon compensation the bank provides, Petitioner has no choice but to maintain reserves with the Federal Reserve in an account on which the Federal Reserve chooses not to pay interest, despite the significant earnings the Federal Reserve generates from such reserves which are taken by the United States. 12 U.S.C. § 461(b)(2).

I. PETITIONER MAINTAINS AN ACCOUNT DIRECTLY WITH THE FEDERAL RESERVE BANK

Respondent's premise that Petitioner has no direct connection to, and thus no ownership interest in, reserve balances which it is required to maintain is entirely incorrect. Apparently, Respondent is unaware that Petitioner, in fact, maintains an account with the Federal Reserve Bank of Dallas. Respondent is mistaken when it asserts that, under 12 U.S.C. § 484, only banks that are members of the Federal Reserve may make withdrawals from a reserve balance and therefore Petitioner must pass its reserves through an account at a member bank. Resp't Br. 6. Respondent overlooks 12 U.S.C. § 461, which expressly provides that a nonmember bank shall maintain reserves in the form of reserve balances in the Federal Reserve Bank at which it maintains an account.[1] The ability to hold reserves on a "pass-through"

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[1] Section 461(c)(1) of title 12 U.S.C. provides:

> Reserves held by a depository institution to meet the requirements imposed pursuant to subsection (b) of this section shall, subject to such rules and regulations as the Board shall prescribe, be in the form of—(A) balances maintained for such purposes by such

basis is simply an alternate method permitted by the Federal Reserve Act. 12 U.S.C. § 461(c)(1)(B). Respondent also overlooks that the Federal Reserve Act expressly empowers the Federal Reserve Bank to receive deposits from Petitioner. 12 U.S.C. § 342.[2] Accordingly, Petitioner has a direct claim on the reserves it maintains in its account at the Federal Reserve Bank of Dallas.

II. PETITIONER'S TAKINGS CLAIM INCLUDES INTEREST EARNED ON RESERVES HELD IN THE FORM OF VAULT CASH AND DEPOSITS AT THE FEDERAL RESERVE BANK

Respondent next contends that Petitioner does not have a property interest in the earnings derived from its required reserves because Petitioner could have held its reserves in the form of cash. Resp't Br. 7, n.1. There is no difference between Petitioner holding its required reserves in the form of vault cash or in the form of balances at the Federal Reserve Bank because the Federal Reserve earns interest on Petitioner's vault cash in the same manner it earns interest on Petitioner's balances held in its reserve account. Both forms of reserves are liabilities of the Federal Reserve Banks and are interchangeable. 12 U.S.C. §§ 342, 414, 415, 461(c), 464. The Federal Reserve generates earnings on vault cash by investing the funds it receives from banks for such cash in interest-bearing securities, just as it invests funds it receives from banks which are held as balances in accounts at the Federal Reserve Banks. Earnings derived from both vault cash and balances are paid by the Federal Reserve to the U.S. Treasury. *See* Income and Expenses of the Federal Reserve

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depository institution in the Federal Reserve bank [sic] of which it is a member or at which it maintains an account . . . .

[2] "Any Federal reserve bank [sic] may receive from any of its member banks, or other depository institutions, and from the United States, deposits of current funds in lawful money . . ." 12 U.S.C. § 342.

Banks, 1914-2004, tbl. 6, *91st Annual Rep.* 2004, Bd. of Governors of the Fed. Reserve Sys.; 12 U.S.C. § 414. The Federal Reserve's earnings on Petitioner's reserves, which have been taken by the United States, are identical regardless of whether reserves are held in an account at a Reserve Bank or by Petitioner in cash. *Hearing Before the Subcomm. on Dom. and Int'l Monetary Policy of the House Comm. on Banking and Fin. Services*, May 3, 1995, 81 *Fed. Reserve Bull.* 676 (July 1995) (statement of Edward W. Kelley, Jr., Member, Bd. of Governors of the Fed. Reserve Sys.). Moreover, Petitioner's complaint sets forth a claim for the income the Federal Reserve earns on Plaintiff's reserves held in the form of vault cash (i.e., Federal Reserve notes) and in the form of deposits at a Federal Reserve Bank. Compl. ¶¶ 6, 29.

Respondent's argument is also in direct conflict with supervisory policy established by the Federal Reserve that directs banks to maintain cash balances at "the minimum levels necessary" to serve customers in order "[t]o avoid having excess nonearning assets and to minimize exposure to misappropriation and robbery . . . ." *Fed. Reserve Commercial Bank Examination Manual* § 2000.1 (Nov. 2000), App. 1a. If Petitioner maintained its reserves solely in the form of vault cash as Respondent suggests, it would face criticism and possible regulatory sanctions from the Federal Reserve by virtue of its failure to minimize the bank's exposure to potential losses and additional risk.

III. PETITIONER'S PROPERTY INTEREST IS DETERMINED BY TEXAS LAW, AS SPECIFIED IN THE FEDERAL RESERVE BANK OPERATING CIRCULAR

Respondent asserts that Texas law does not apply to Petitioner's deposits with the Federal Reserve Bank. Resp't Br. 8, n.2. Respondent apparently is unaware that the account relationship between Petitioner and the Federal Reserve Bank

of Dallas is controlled by Federal Reserve Operating Circular 1, Account Relationships (eff. Sept 1, 2002), App. 2a.[3] Operating Circular 1 sets forth the terms for opening, maintaining and terminating the account which Petitioner maintains with the Federal Reserve Bank of Dallas. The Operating Circular expressly provides that it "shall be governed by Federal law and, to the extent not inconsistent with Federal law, by the laws of the State in which the Reserve Bank's head office is located." App. 5a. The head office of the Federal Reserve Bank of Dallas is located in Texas.[4] Accordingly, by the terms of the Federal Reserve's own agreement governing its relationship with Petitioner, Petitioner's property interest in its reserve account is established in accordance with Texas law, which has long recognized that interest follows principal. *See Phillips*, 524 U.S. at 166; *Webb's*, 449 U.S. at 162.

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[3] Operating Circulars are issued by the Federal Reserve Banks to establish and determine the legal terms and conditions under which the Federal Reserve Banks provide services to depository institutions. There are 12 Operating Circulars currently in effect. http://www.frbservices.org/OperatingCirculars/index.html.

[4] The Federal Reserve Bank of Dallas, About the Dallas Fed, http://www.dallasfed.org/fed/dallas.html.

CONCLUSION

For the foregoing reasons, and those stated in the petition, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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May 25, 2006

APPENDIX

APPENDIX A

Federal Reserve Board, Comm. Bank Exam. Manual, Cash Accounts § 2000.1 (Nov. 2000).

CASH

Every bank maintains a certain amount of U.S. currency and some may have foreign currency on hand. To avoid having excess nonearning assets and to minimize exposure to misappropriation and robbery, each bank should establish a policy to maintain cash balances at the minimum levels necessary to serve its customers. The amount will vary from bank to bank depending on anticipated needs of customers and the availability of replenishment monies, with a reasonable allowance made for unusual demands.

* * * * *

APPENDIX B

Federal Reserve Operating Circular 1, Account Relationships (eff. Sept. 1, 2002)

1.0 INTRODUCTION

1.1 SCOPE

This operating circular and its appendices ("Circular") set forth the terms for opening, maintaining, and terminating a master account with a Federal Reserve Bank ("Reserve Bank"). It also contains general provisions regarding Reserve Bank services applicable to an institution whether or not it maintains an account at a Reserve Bank. Each Reserve Bank has issued an operating circular identical to this one.

An account is subject to Federal Reserve regulations and policies, such as those on payments system risk, reserve balances, and clearing balances, as they may be revised from time to time. An institution also should be familiar with Operating Circular 10, Lending, and other Reserve Bank operating circulars governing specific services. These circulars may be found on the Internet at http://www.frbservices.org, and copies may also be obtained from each Reserve Bank.

1.2 DEFINITIONS

a) **Master Account** or **Account** means the record of financial rights and obligations of an account holder and the Reserve Bank with respect to each other, where opening, intraday, and closing balances are determined.

b) **Subaccount** means an information record of a subset of transactions that affect the master account. A subaccount does not reflect balances but does contain totals of debit and credit activity.

c) **Correspondent** means an institution that has authorized a Reserve Bank to make debits and credits to its master account on behalf of one or more other (respondent) institutions. The